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# GLOBAL OPPORTUNITY KNOCKS: THE EVOLUTION OF DISTRESSED INVESTING

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# GLOBAL OPPORTUNITY KNOCKS:
# THE EVOLUTION OF DISTRESSED INVESTING

Oaktree has always believed in speaking plainly. That's why we describe our approach to distressed investing in simple terms: we look for "good companies with bad balance sheets." This description made sense in 1985 when our co-founder Bruce Karsh became a pioneer in this investment style, in 1988 when the fund that laid the foundation for our Distressed Debt platform was created, and in 1995 when Oaktree officially opened its doors. And distressed investing has remained a pillar of our business for 25+ years, yet as the definition of corporate distress has evolved, so too has our investing approach.

Key factors affecting the credit cycle have changed since our founding. For one, debt has become much less expensive, as interest rates have trended downward for four decades. The yield on the 10-year Treasury note topped 15.0% in the early 1980s, fell to 7.88% by the beginning of 1995, and is 1.58% today.[1]

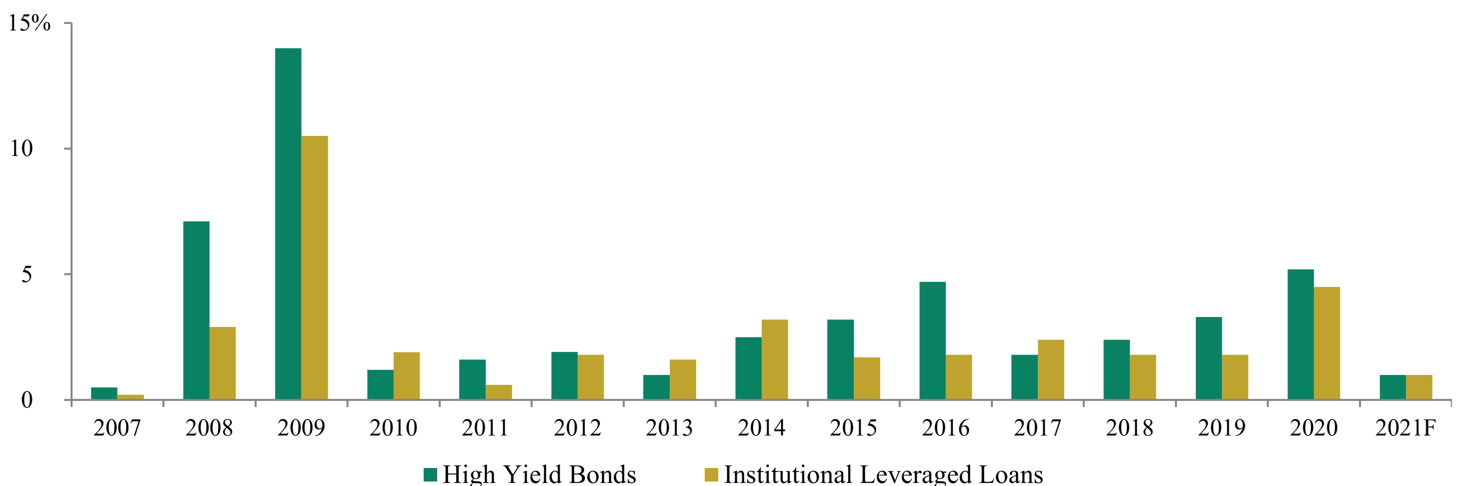
Additionally, the default environment has become more benign. Default rates for high yield bonds and leveraged loans fell rapidly after spiking during the Global Financial Crisis of 2008-09 and have spent the majority of the last decade well below their long-term historical averages (see Figure 1).[2]

This decline was largely due to macroeconomic trends. The economic expansion that followed the GFC lasted for 128 months – the longest in U.S. history. During this prolonged recovery, companies' fundamentals improved, credit risk declined, and yield spreads narrowed.

Ultra-accommodative monetary policy played a major role in limiting default activity. After the collapse of Lehman Brothers in 2008, the U.S. Federal Reserve sought to restore market stability and support the economy by slashing short-term interest rates to zero and flooding the financial system with liquidity. The Fed's balance sheet, which held around $900 billion in assets at the beginning of 2008, swelled to approximately $4.5 trillion by the end of 2014 (see Figure 2). These actions reduced investors' interest in high grade debt, boosted appetites for low-rated debt, and made it easier for companies to secure financing – including firms with high debt-to-earnings ratios.

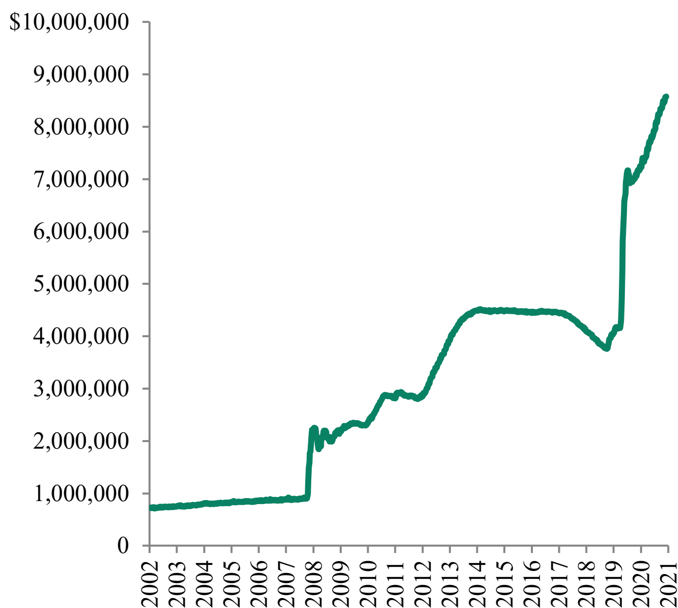
The Fed acted even more aggressively in 2020 when the Covid-19 crisis was roiling markets and shuttering much of the global economy. The central bank's balance sheet increased by roughly $2 trillion in a matter of weeks. That figure has since ballooned to more than $8.5 trillion – an unprecedented expansion of liquidity. As a result, the double-digit default rates that credit ratings agencies had forecast in early 2020 never materialized.[3]

*Figure 1: The Rise and Fall of U.S. Default Rates*




*Source: Fitch Ratings*

*Figure 2: The Federal Reserve's Ballooning Balance Sheet*




*Source: Board of Governors of the Federal Reserve System (US)*[4]

Distressed investing has evolved and expanded during the last four decades as market realities – and potential opportunities – have changed. We believe the right move has been to broaden one's mandate, eschewing boundaries – including those around countries, investment areas, sectors and forms of ownership. By doing so, an investor (1) is well positioned to take advantage of dislocation wherever it occurs and (2) has the flexibility to tackle non-distressed situations in which a background in distressed credit can be a potential advantage.

Categorization helps investors make sense of a complex financial world, but the terms we use to describe our activities need to be updated to keep pace with the times. That's why Oaktree recently changed the name of its flagship Distressed Opportunities strategy to Global Opportunities. We believe this new name better reflects the evolution of our approach as well as the market-wide changes that have reshaped the business of buying assets for less than they're worth.

## "GOOD COMPANY, BAD BALANCE SHEET"

Distressed debt investors have traditionally bought the liabilities of companies that are in bankruptcy or otherwise appear unlikely to meet their financial obligations. The preferred target is a business with too much debt but also a strong underlying business, valuable assets, and/or the ability to generate cash. Such companies may struggle to service their debt during economic downturns. These overleveraged companies often reduce their debt by going through a restructuring either within or outside of bankruptcy court, whereby most creditors agree to exchange old debt for new securities worth less than 100 cents on the dollar.

Experienced investors can potentially add value by taking a leadership role in this restructuring process. They can craft solutions that leave the company with sufficient liquidity and a sustainable balance sheet, and they can try to use their influence to either recover the full value of their claim or gain control of the company by having their debt converted into equity with upside potential. As owners, these investors can help the company complete a financial turnaround.

The size of the distressed opportunity set has historically been correlated with the credit cycle. Companies are likely to struggle to service or roll over their debt – and therefore see their debt trade at distressed levels – when markets are falling, the economy is slowing or contracting, and the majority of investors are increasingly risk averse. However, this relationship has become less pronounced in recent years as investors in distressed opportunities have broadened their scope beyond public debt and companies facing Chapter 11 bankruptcy.

During the Covid-19 crisis, default rates for high yield bonds and leveraged loans rose above pre-pandemic levels, but never approached the double-digits heights seen during prior crises. Yet distressed investors with global networks and access to large amounts of capital were still able to find attractive opportunities – especially in sectors most exposed to the pandemic, such as retail, travel & leisure, real estate and energy. We believe the investors best positioned to seize these opportunities were those who had spent decades broadening their investment repertoire.

## EXPANDING THE PLAYBOOK

Investors in distressed opportunities benefit by being able to dispassionately analyze securities and companies; stomach potential illiquidity; control their emotions; and add value, including by leading restructurings, crafting creative financing solutions, and engineering financial turnarounds. Investors may have honed these tools in traditional distress scenarios, but in recent years, some investors have used this skillset to tackle situations in which companies aren't involved in a bankruptcy process or where solvency isn't the primary concern.

The evolution of this investment style has been a gradual process. In the late 1980s, investors like Oaktree's principals, who focused on distressed assets, were primarily targeting U.S. high yield bonds. The opportunity set eventually expanded to include bank debt, mortgages and opportunities

in growing non-U.S. markets. In the 1990s, distressed opportunities investors increasingly began exploring situations that were complex but not classically distressed, especially those in illiquid markets or niche industries in which companies' access to capital was limited.

In the decade following the GFC of 2008-09, investors began finding opportunities in an ever wider array of areas, such as direct lending, portfolios of non-performing bank loans, real-estate-related debt, specialty-finance platforms and structured credit, among others. Experienced investors found that private credit and other complex opportunities could – like traditional distressed debt – provide the combination of significant upside potential and strong downside protection.

Investors with a distressed debt heritage also discovered that they potentially had a competitive edge in areas such as direct lending or structured equity because they had decades of experience structuring deals, unlike their competitors whose backgrounds were in non-distressed leveraged finance.

Distressed credit has continued to play a significant role in the strategies of many opportunistic investors and will likely continue to do so moving forward, given that sector- and company-specific dislocations occur even when markets are strong and default rates are low overall. But locating these opportunities, tackling them quickly, and avoiding the value-reducing pitfalls common in today's expensive bankruptcy system is challenging and often requires extensive experience, market relationships and a large capital base.

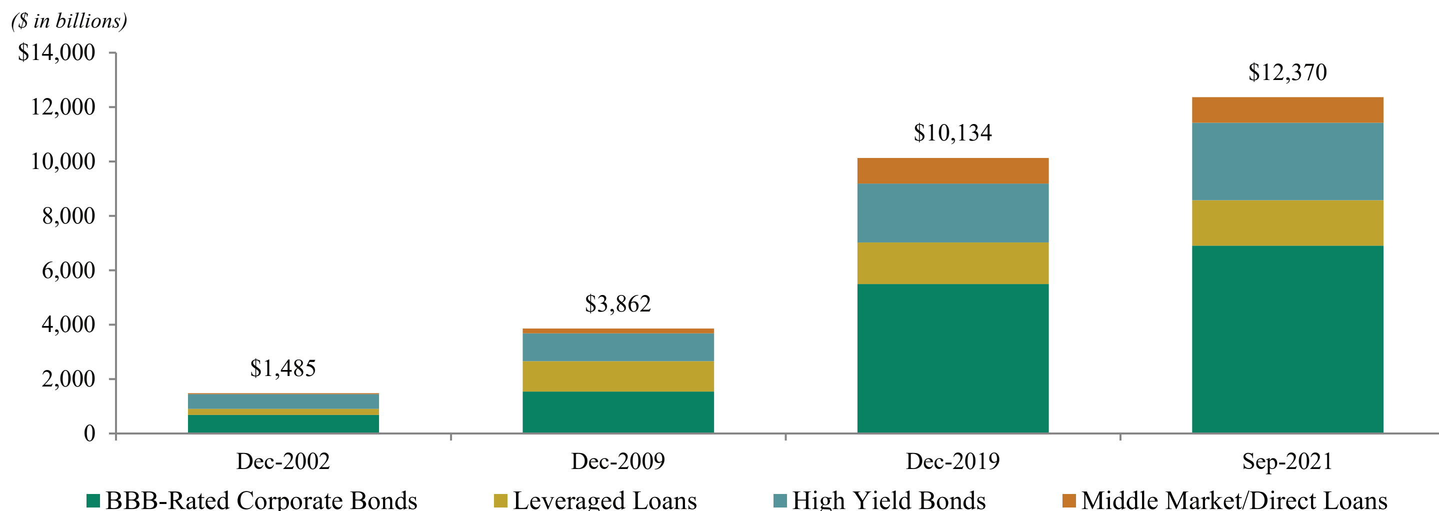
## EXPANDING THE FOOTPRINT

Investors have also benefitted by broadening their geographic scope. Distressed debt pioneers like Oaktree originally focused mostly on opportunities in North America, where a dependable rule of law protected creditor rights and one could find a significant number of good companies with bad balance sheets. The investment universe first widened to include Western Europe, especially after the onset of the eurozone crisis, and then expanded much further, as international debt markets grew and many countries' bankruptcy laws were modernized. Firms increasingly began to explore the widening opportunity set in Asia, particularly in China and India.

Investors with large global teams can now target distressed and non-distressed situations in many developed and emerging markets, meaning such investors aren't entirely dependent on any one country's credit cycle.

Global distressed opportunities may increase in the aftermath of the pandemic, as many companies will be navigating an uncertain environment while carrying significant debt loads. The amount of low-rated global debt outstanding has skyrocketed in the last decade, more than tripling since December 2009 to approximately $12.4 trillion today (see Figure 3). The opportunity set in China may continue to grow, as default rates in 2021 for Chinese high yield bonds and the debts of the country's real estate sector are expected to top 13% and 20%, respectively, according to JP Morgan.[5] Additionally, complex and idiosyncratic situations not involving bankruptcies may arise that require creative, well-structured financing solutions.

*Figure 3: The Growth of Low-Rated Global Corporate Debt*




*Sources: Bloomberg Barclays, Credit Suisse, ICE BofA, Preqin, Cliffwater, Refinitiv. Middle Market/Direct Loans data as of August 2021.[6]*

## SEIZING THE GLOBAL OPPORTUNITIES

Oaktree's Opportunities group has always been guided by the core tenets that the firm's co-founders drafted in 1995, including the primacy of risk control and the importance of consistency. Our overarching strategy remains unchanged: we provide bespoke financing solutions to companies with limited access to capital, while striving to secure significant downside protection.

But our Opportunistic Credit platform has evolved and expanded over the last few decades, outgrowing its original name. Our team now has 56 members, including dedicated investment professionals, restructuring experts and traders, spread over five offices and three continents. And our mandate, which in 1988 was limited to North American high yield bonds, now spans a wide array of geographies and investment areas, including both public and private markets.

We've long prided ourselves on our ability to invest throughout the market cycle, and we believe our strategy's gradual expansion and extensive resources have vastly increased the number of avenues that we can use to continue doing so. Much about the newly renamed Global Opportunities strategy hasn't changed. But we believe the name of our strategy now covers as much territory as we do.

### BRUCE KARSH

*Co-Chairman, Chief Investment Officer and Portfolio Manager*

Mr. Karsh is Oaktree's Co-Chairman and one of the firm's co-founders. He also is Chief Investment Officer and serves as portfolio manager for Oaktree's Global Opportunities, Value Opportunities and Multi-Asset Credit strategies. Prior to co-founding Oaktree, Mr. Karsh was a managing director of TCW Asset Management Company, and the portfolio manager of the Special Credits Funds from 1988 until 1995. Prior to joining TCW, Mr. Karsh worked as Assistant to the Chairman of SunAmerica, Inc. Prior to that, he was an attorney with the law firm of O'Melveny & Myers. Before working at O'Melveny & Myers, Mr. Karsh clerked for the Honorable Anthony M. Kennedy, then of the U.S. Court of Appeals for the Ninth Circuit and retired Associate Justice of the U.S. Supreme Court. Mr. Karsh holds an A.B. degree in economics summa cum laude from Duke University, where he was elected to Phi Beta Kappa. He went on to earn a J.D. from the University of Virginia School of Law, where he served as Notes Editor of the Virginia Law Review and was a member of the Order of the Coif. Mr. Karsh serves on the boards of a number of privately held companies. He is a member of the investment committee of the Broad Foundations. Mr. Karsh is Trustee Emeritus of Duke University, having served as Trustee from 2003 to 2015, and as Chairman of the Board of DUMAC, LLC, the entity that managed Duke's endowment, from 2005 to 2014.

### ROBERT O'LEARY

*Global Co-Portfolio Manager and Head of North America*

Mr. O'Leary, Global Co-Portfolio Manager and Head of North America for Oaktree's Global Opportunities strategy, leads all of the group's investment activities in the region. He contributes to the analysis, portfolio construction and management of the Global Opportunities, Value Opportunities and Strategic Credit strategies. Prior to joining the firm in 2002, Mr. O'Leary served as an associate at McKinsey & Company, where he worked primarily in the Corporate Finance and Strategy practice. Before attending Harvard Business School, Mr. O'Leary worked for two years at Orion Partners, a private equity firm, where he focused on investments in private companies. Prior thereto, he worked at McKinsey & Company as a business analyst. Mr. O'Leary graduated with a B.A. degree in economics magna cum laude from Pomona College and an M.B.A. in business administration from Harvard Business School.

### PEDRO URQUIDI

*Global Co-Portfolio Manager and Head of Global ex-North America*

Mr. Urquidi, Global Co-Portfolio Manager and Head of Global ex-North America for the Global Opportunities strategy, leads all of the group's investment activities outside of North America. Mr. Urquidi joined Oaktree's London office in 2005 and subsequently built, led and managed the European and Asian Opportunities teams from there before relocating to Hong Kong in 2019 to also help develop and grow the firm's investment activities in the region. During his tenure at Oaktree he has also served on various Boards including Eolia Renovables and TI Automotive. Prior to joining Oaktree in 2005, Mr. Urquidi spent ten years at Morgan Stanley & Co., where from 2001 to 2004 he built, led and managed Morgan Stanley's European Special Situations Group in London as well as served as overall risk manager for the firm's European high yield, bank debt and distressed debt businesses. Between 1994 and 2001, he worked in New York and Hong Kong as a trader in Morgan Stanley's Global High Yield group, including roles as Head of Emerging Market Corporate Trading and senior high yield trader. Mr. Urquidi graduated with an A.B. degree in economics from Princeton University and an M.B.A. in finance from Columbia Business School.

## ENDNOTES

[1] The yield on the 10-year Treasury note is as of November 12, 2021.

[2] Fitch Ratings.

[3] JP Morgan.

[4] Total assets less eliminations from consolidation; Wednesday level.

[5] Forecast as of October 14, 2021.

[6] For each period, data is as of the last day of month. For 2021, the high yield bond figure is estimated from BofA All Maturity Global High Yield Index; the leveraged loans figure is estimated from the Credit Suisse Global Leveraged Loan Index; the BBB-rated corporate bond figure is estimated from BofA Global Corporate Index, BofA 0-1 year US Corporate Index, BofA 0-1 year Euro Broad Market Index, BofA 0-1 year Emerging Markets Corporate Plus Index, and BofA 0-1 year China Broad Market Index. For 2002 and 2009, high yield bond data came from the BofA Global High Yield Index because the BofA All Maturity Global High Yield Index was created in 2011. In 2002 and 2009, leveraged loan size was estimated using the Credit Suisse Leveraged Loan Index and the Western European Leveraged Loan Index. In 2002 and 2009, the BBB-rated corporate bond figure was estimated using the Bloomberg Barclays Global Aggregate Corporate Index – Baa. The middle market/direct loans figure used Refinitiv estimates for 2019 and Preqin private markets estimates for 2002 and 2009.

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